

Docket No. 14-0496

Rebuttal Testimony of

Michael P. Gorman

On behalf of

City of Chicago and the Citizens Utility Board

January 15, 2015



Rebuttal Testimony of Michael P. Gorman

1 **Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2 A Michael P. Gorman. My business address is 16690 Swingley Ridge Road, Suite 140,
3 Chesterfield, MO 63017.

4 **Q ARE YOU THE SAME MICHAEL P. GORMAN WHO PREVIOUSLY FILED**
5 **TESTIMONY IN THIS PROCEEDING?**

6 A Yes. On November 26, 2014, I filed Direct Testimony on behalf of the City of
7 Chicago (“City”) and the Citizens Utility Board (“CUB”).

8 **Q WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?**

9 A I will respond to certain arguments made in the Joint Applicants’¹ rebuttal testimony.
10 Specifically, I will respond to the Rebuttal Testimony of Joint Applicants witnesses
11 Allen L. Leverett (JA Ex. 6.0), Scott J. Lauber (JA Ex. 7.0) and John J. Reed (JA
12 Ex. 8.0).

13 These witnesses respond to my recommendations concerning a five-year rate
14 freeze, a prohibition on transition cost recovery in retail rates, and my proposal for a
15 dividend payment restriction (or ring-fence restriction) to ensure that PGL and NS are
16 able to prioritize system modernization capital investments above making payments to

¹Wisconsin Energy Corporation (“WEC”), Integrys Energy Group, Inc. (“Integrys” or “TEG”), Peoples Energy, LLC, The Peoples Gas Light and Coke Company (“PGL”), North Shore Gas Company (“NS”), ATC Management Inc., and American Transmission Company LLC.

their parent company over the next 10 years. The Joint Applicants' responses and my rebuttal to them are organized by each of these recommendations below.

Rate Freeze

Q WHAT COMMENT DO YOU HAVE CONCERNING JOINT APPLICANTS WITNESS ALLEN LEVERETT'S OPPOSITION TO YOUR RATE FREEZE RECOMMENDATION?

A Mr. Leverett takes issue with my recommendation that the Illinois Commerce Commission ("ICC" or "Commission") approve the proposed merger and acquisition only if the Joint Applicants agree to a five-year freeze in base rates. He concludes that this five-year rate freeze condition for approval for the acquisition is unreasonable. At page 34, he cites several issues in support of this testimony:

1. He notes that only PGL has a Rider Qualifying Infrastructure Plant ("QIP"), whereas NS can only recover its capital investments by filing for a change in base rates.
2. He states that Rider QIP is subject to a cap based on the percentage of PGL's base rates that can only be reset by filing for a change in base rates.
3. He states that this restriction fails to recognize the various updates to Chicago Department of Transportation ("CDOT") regulations outlined by City/CUB witness Mr. Cheaks that have led to dramatic increases in costs of performing necessary work upon PGL facilities in the City.

Q DID JOINT APPLICANTS WITNESS JOHN REED ALSO RESPOND TO YOUR PROPOSED FIVE-YEAR RATE FREEZE MERGER CONDITION?

A Yes. Mr. Reed also concludes that a five-year rate freeze is not a reasonable condition for approval of the merger. He states that such a proposal would not be consistent

with his interpretation of the legal effect of the Public Utilities Act's ("PUA") list of specific threshold criteria for approval of such transactions. Mr. Reed focuses on the following:

- a. Reorganization will not diminish service quality.
- b. Reorganization will not result in unjustified subsidization of non-utility activities by the utility or its customers.
- c. Reorganization will not significantly impair the utility's ability to access capital on reasonable terms.
- d. Reorganization will not have a significant adverse effect on competition or adverse impact on retail rates. (Page 16).

Mr. Reed concludes that based on the meaning he gives to these factors, my proposed conditions are not consistent with the PUA. Since neither I am nor Mr. Reed is a lawyer, the validity of his interpretation of the 7-204(b) necessary (but not expressly sufficient for approval) Commission findings will be addressed in briefs.

Q PLEASE RESPOND TO THE JOINT APPLICANTS' OTHER RESPONSES TO YOUR FIVE-YEAR BASE RATE FREEZE PROPOSAL.

A I believe a rate freeze would be appropriate and reasonable under current circumstances, which include the following factors: (a) recognizing the importance of programs to modernize the utilities' aged infrastructure, (b) that significant portions of PGL's capital investments will be subject to recovery through Rider QIP, and (c) that other revenues are also subject to recovery through revenue stabilizing mechanisms. As noted in my Direct Testimony, over 70% of PGL's planned capital expenditures will be covered by the QIP Rider. This leaves a smaller portion of capital

64 expenditures to be recovered through base rates. The amount of annual capital
65 expenditures to be recovered through base rates is approximately equal to the amount
66 of annual depreciation expense recovered by the utilities each year in utility non-fuel
67 revenue receipts. Therefore, the capital additions to base-rate rate base will offset
68 declines to the same rate base caused by depreciation expense recovery. The result,
69 base-rate rate base will have limited to no increase over the next five years. Hence, a
70 five-year rate freeze would still allow PGL to fully recover its cost of service at
71 current rates.

72 I will acknowledge, that this may be more difficult for NS, to the extent it does
73 not have a QIP Rider in effect. Nevertheless, five-year base rates should be
74 manageable for PGL based on the other rider mechanisms currently available to NS.
75 Further, to the extent the proposed acquisition can create any savings, under the Joint
76 Applicants' proposed treatment of such savings, those most of those savings will
77 likely be retained by PGL and NS t, and defer the need for any rate increases. (DRR
78 City 10.49-10.53, 10-55, attached as City/CUB Exhibit 8.1). A rate freeze period will
79 incent PGL and NS to maximize the amount of savings that can be generated through
80 this reorganization.

81 City-CUB noted in their direct testimony that any assessment of the impact of
82 Chicago CDOT regulations should take account of PGL management's use or failure
83 to use savings opportunities also included in the regulations. The Joint Applicants
84 have not acknowledged or taken account of such savings opportunities.

85 **Transition Cost Recovery**

86 **Q WHAT ISSUES DOES MR. LAUBER RAISE RESPECTING YOUR DIRECT**
87 **TESTIMONY?**

88 A In my Direct Testimony, I recommended the Joint Applicants not be allowed to
89 include transition costs in their cost of service for retail rates in Illinois. Mr. Lauber
90 takes issue with this, stating that certain transition costs may be necessary to create
91 cost of service savings. Therefore, he concludes that it is reasonable to recover
92 transition costs as long as the savings are sufficient to cover the costs included in rates.

93 **Q PLEASE RESPOND TO MR. LAUBER'S TESTIMONY.**

94 A I agree with Mr. Lauber that to the extent the Joint Applicants implement procedures
95 that require the Joint Applicants to incur costs that produce savings, the Joint
96 Applicants should be allowed to recover the cost up to the level of savings created.
97 However, in a rate case where the Joint Applicants seek to include transition costs in
98 their cost of service, the burden of proving that the transition cost is reasonable and
99 created documented savings, should fall on the Joint Applicants. The burden of
100 proving whether or not the transition costs incurred were prudent and reasonable and
101 produce verifiable savings should not fall on other parties to the rate case. In the
102 absence of suitable proof, any imprudent, unreasonable or unproven transition costs
103 and any costs of achieving unproven savings, should be the responsibility of the Joint
104 Applicants or the utility, not ratepayers.

105 Also, transition cost treatment in rate cases should be clearly defined.
106 Transition costs can produce savings over time, which may not be level annualized

savings amounts. Therefore, it is possible that costs for a transition initiative incurred in a test year in a rate-setting proceeding, may be offset by the savings produced in the same test year, but the total cost of that initiative may not be covered by total expected or actual savings over the life of the project. Permitting the Joint Applicants to include transition costs in the development of rates, under certain circumstances, should be clearly limited by the principle that transition costs will never be allowed to increase the Joint Applicants' revenue requirement and retail rates. Hence, if transition costs are included in a test year, then the Joint Applicants have the burden of proving that there are savings within the test year and over the life of the project that fully offset the level of transition costs. It is not appropriate for the Joint Applicants to suggest that savings will increase over time and, thus, argue for collection of test year costs that exceed net savings.

Allowing for recovery of transition costs that are not fully offset by savings created specifically by those activities, will result in an increase (inconsistent with the JAs' commitment) in the revenue requirement and retail rates within a rate case. Moreover, without appropriate accounting requirements, any net savings that are realized outside the test year will completely flow to the benefit of the Joint Applicants.

For these reasons, the Joint Applicants should assume the full burden of proving that test year transition costs-to-achieve (for a particular savings project/initiative) included in rates are fully covered by net savings, and the test year costs will be fully offset by the test year savings created.

129 **Q DID MR. REED RESPOND TO YOUR PROPOSAL FOR NO TRANSITION**
130 **COST RECOVERY?**

131 A Yes. At pages 17 and 18 of his testimony, he makes arguments similar to Mr.
132 Lauber's. Specifically, he argues that to the extent transition costs are incurred that
133 produce savings, the utility should be allowed to recover the transition costs up to the
134 amount of savings produced. My response to Mr. Lauber is sufficient in responding to
135 Mr. Reed's arguments, which are nearly identical to those of Mr. Lauber.

136 **Dividend Payment Restrictions**

137 **Q DOES MR. LAUBER ALSO TAKE ISSUE WITH YOUR PROPOSED**
138 **RING-FENCE RESTRICTIONS ON DIVIDEND PAYMENTS AS A**
139 **CONDITION OF THE MERGER?**

140 A Yes. At page 9 of Mr. Lauber's Rebuttal Testimony, he states that the Commission
141 should not impose a ring-fence restriction on payment of dividends as part of the
142 proposed transaction. In my Direct Testimony, I recommended that the Commission
143 require, as a condition of reorganization approval, the Joint Applicants restrict
144 dividend payments if Illinois utilities do not fulfill their obligations (both in amount
145 and as to timing) to make distribution system modernization capital improvements. I
146 believe this ring-fence protection is necessary to ensure that the utilities' system
147 modernization programs are given a higher priority by the Joint Applicants than
148 payment of dividends from the utilities up to the parent company. I believe this is
149 particularly necessary due to the significant amount of acquisition-related debt
150 proposed to be incurred by WEC to fund the proposed transaction. The only cash

available to WEC that is not needed to fund its debt service and public dividend payments are cash payments (dividends) from its utility subsidiaries.

Q WHY DO THE JOINT APPLICANTS BELIEVE THE RING-FENCE RESTRICTION IS NOT NEEDED?

A Mr. Lauber believes this is unnecessary for the following reasons:

1. The PUA already has a restriction on dividend payments from the utility to the parent company. Section 7-103(2) of the PUA prohibits a utility from paying any dividend unless its earnings and earned surplus are sufficient to declare and pay such dividend, and after payment the utility has reasonable and proper reserves. He states the PUA prohibits a dividend payment without impairment of the ability of the utility to perform its duty to render reasonable and adequate service at reasonable rates.

Joint Applicant witness John Reed also takes issue with my proposed ring-fence protections. He states that this is unnecessary for the following reasons:

1. He states that I provided no evidence that the proposed reorganization will reduce WEC's ability to raise capital on reasonable terms and conditions to fund its capital spending requirements. He notes Standard & Poor's ("S&P") is not concerned about the cash impact on WEC. (JA Ex. 8.0 at 20).
2. He states that I ignore the typical practice for utilities to go to the marketplace to seek capital to fund capital improvement budgets rather than to fund them from internal sources. He states that as long as the utility has a reasonable opportunity to earn an adequate return, it will continue to invest in rate base, and will be able to seek funding from the capital markets to support that rate base investment.

Therefore, he implies that a dividend restriction is not necessary. (JA Ex. 8.0, lines 396-404).

176 **Q DO YOU BELIEVE THAT THIS PUA LIMIT ON PAYMENT OF DIVIDENDS**
177 **IS AN ADEQUATE SUBSTITUTE FOR THE JOINT APPLICANTS' CLEAR**
178 **COMMITMENT THAT MEETING THEIR CAPITAL IMPROVEMENTS**
179 **WILL TAKE PRECEDENCE OVER PAYING DIVIDENDS?**

180 **A No.** The PUA dividend restriction is based on whether or not there are adequate
181 earned surplus or retained earnings to permit the utility to pay dividends. This is a far
182 different standard than receiving a bonafide assurance from the Joint Applicants that
183 meeting their system modernization capital program will have a higher priority than
184 making dividend payments up to WEC. This is particularly important since WEC will
185 be taking on additional significant financial obligations as a result of its funding
186 sources for the proposed transaction.

187 Under the PUA restriction, a utility will not be allowed to pay dividends if its
188 earnings and earned surplus are not sufficient to allow the utility to declare and pay the
189 dividend. That provision requires prior notice of a proposed dividend action only
190 when the utility acknowledges that the dividend would not be consistent with the
191 statutory criteria. Under such circumstances, the utility may be in a position where it
192 can neither afford to pay dividends nor afford to meet its full capital expenditure
193 program requirements. Hence, the PUA dividend restriction is designed to protect the
194 financial integrity of the utility during distressed financial periods.

195 In contrast, the dividend restriction I recommend is intended to produce a
196 bonafide commitment from the Joint Applicants that making the capital improvements
197 needed for system modernization will be prioritized before dividends will be paid to
198 WEC. Under my proposed merger condition, PGL and NS may be in an adequate
199 financial position to make a dividend payment to WEC, and may choose to make a
200 dividend payment (or increased dividend payment) rather than meet their full
201 obligation (amount and timing) to make capital improvements needed for system
202 modernization. Because of the need for system modernization, to improve service
203 reliability and safety, PGL's and NS's obligation to pursue the amount and timing of
204 these capital improvements should be honored by the Joint Applicants, and prioritized
205 over making dividend payments to WEC.

206 **Q DID MR. REED HAVE QUESTIONS RELATED TO YOUR PROPOSED**
207 **RING-FENCE RESTRICTION AS A CONDITION OF THE MERGER?**

208 **A**Yes. He states at page 20 of his testimony, that at one point in my testimony I asserted
209 that PGL and NS should be required to fund their capital investments before dividends
210 are increased, while at page 22 I state that the companies should not be able to make
211 dividend payments or other cash transfers to WEC before the capital programs are
212 fully funded.

213 **Q PLEASE RESPOND.**

214 **A**To be clear, it is my position that, as a condition of the reorganization, funding the
215 utilities' capital programs should take precedence over dividend payments by PGL and

NS to WEC. As such, to the extent the timing and full funding of the capital programs during the system modernization are not completed, PGL and NS should either limit their dividend payments, or eliminate dividend payments to the extent necessary to ensure that the capital improvements are made on a timely basis. To the extent these capital improvements are necessary to maintain service reliability and safety to the public, they should be prioritized as a condition of the merger.

**Q DO YOU BELIEVE YOUR RING-FENCE PROVISION IS A REASONABLE
CONDITION FOR THE MERGER?**

A Yes. I do not dispute that the Joint Applicants' projections and S&P's outlook suggest that the Joint Applicants will have adequate cash flows to support their acquisition-related debt, and to fund their planned capital improvement program. If things go as the Joint Applicants project, ring-fence protections to ensure the utilities can fund their capital improvement programs will have a *de minimis* impact on the Joint Applicants' financing and capital investment plans, and there should be no objection to a condition they assert will never come into play.

However, these ring-fence provisions will act as insurance to protect customers, in the event the expected outlook for the Joint Applicants' cash flows and ability to fund capital improvement plan are weaker than forecasted by the Joint Applicants. If WEC has cash flow restrictions, and cannot fund both capital improvements and public dividends, one of the two will need to be adjusted.

The ring-fence protections will be important from a public safety and system reliability standpoint, if PGL and NS are placed in a position where they have to

238 choose between making dividend payments demanded by WEC, or reducing the
239 amount of capital investments they plan in their system modernization and reliability
240 improvements. As such, this condition of the merger simply provides assurance to
241 customers and the public that the Joint Applicants will prioritize making system
242 modernization and reliability improvements to the PGL and NS distribution systems,
243 before making dividend payments to the parent company in support of the acquisition-
244 related debt.

245 **Q DID MR. REED MAKE COMMENTS CONCERNING YOUR**
246 **DEMONSTRATION OF THE POTENTIAL CASH FLOW LIMITATIONS**
247 **FROM UTILITY COMPANIES UP TO WEC IN SUPPORT OF THE**
248 **ACQUISITION-RELATED DEBT?**

249 **A** Yes. Mr. Reed states that my analysis showing the source of cash flow available to
250 WEC, in support of WEC's existing debt and public dividend payment outlooks, is not
251 convincing. He states that the acquisition-related debt will not be an amortized debt
252 schedule as I reflected, but rather will be based on a public debt issuance. He also
253 implies that the proposed reorganization should enhance WEC's access to capital, and
254 therefore mitigate any concern about receiving dividend payments from the utilities to
255 support the financial obligation at the parent company level. (Reed Rebuttal
256 Testimony, JA Ex. 8.0 at 20-22).

257 **Q PLEASE RESPOND.**

258 **A**Mr. Reed simply has not provided an adequate justification for not requiring financial
259 assurances (from the Joint Applicants) that funding system modernization will be
260 placed at a priority above making dividend payments from Illinois utilities up to WEC.
261 The Joint Applicants' own projections suggest that there may be limitations on the
262 availability of cash flow to utility companies, so that available cash flow can be used
263 to support the financial obligations at the parent company level. If the parent
264 company's financial projections are not realized, and things are more stressed or
265 constrained than the Joint Applicants project, it is possible that the parent company
266 may look to the utilities for greater cash resources to support its materially increased
267 financial obligations produced by the material debt used to fund this transaction.

268 In this instance, the parent company's need for cash flow from the utilities may
269 restrict the utilities' ability to both fund capital improvements and meet the parent
270 company's dividend payment demands. In this instance, the utility companies,
271 including PGL and NS, may be placed in the position of choosing between meeting
272 the dividend payments demanded by WEC, and fulfilling their commitments to
273 modernize their distribution system and improve service reliability and safety in a
274 timely manner.

275 The proposed ring-fence protections and concession by the Joint Applicants
276 simply would provide assurance to the Illinois Commission, and the customers and
277 service territories served by PGL and NS, that system modernization projects will be
278 prioritized above dividend payments to the parent company. Thus, the Joint
279 Applicants will be committing to the ICC that required maintenance or improvement

in service reliability and safety to customers served by PGL and NS is a top priority if the transaction is approved. Such pressures would not be expected under the current ownership arrangement, which is not burdened by enormous acquisition debt.

Q PLEASE RESPOND TO JOINT APPLICANTS WITNESS REED'S SUGGESTION THAT THE REGULATORY MECHANISMS FOR PGL AND NS WERE IN PLACE PRIOR TO THE PROPOSED TRANSACTION, AND THEREFORE DID NOT CONTRIBUTE TO THE TRANSACTION PREMIUM IN THIS CASE.

A I do not dispute that the regulatory mechanisms were in effect prior to the proposed transaction. However, the regulatory mechanisms stabilized PGL's and NS's ability to recover their revenue requirement, which in any reasonable assessment of the valuation of PGL and NS had a positive impact and contribute to the premium being paid in the acquisition..

Because the Joint Applicants are paying a premium to the prevailing book value and market value of Integrys Energy Group, Inc., and propose to fund a large portion of that acquisition premium using additional acquisition related debt, the proposed transaction will create significantly more financial risk at WEC. This debt funding will place a significant financial burden on WEC after the transaction is completed. The proposed financing for the proposed transaction creates a significant increase in the parent company level debt, and therefore justifies assurances from the Joint Applicants that PGL and NS will prioritize system modernization and reliability improvements ahead of dividend payments to their parent company. This ring-fence

302 provision as a condition of the merger approval creates assurance from the Joint
303 Applicants that capital improvements will be prioritized before dividend payments.

304 **Q DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

305 **A** Yes, it does.

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